United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

Docket No. 75-4138

IN THE

United States Court of Appeals

For the Second Circuit

GERALD F. PADUANO and CAROLINE PADUANO,

ROCCO M. CAPPUCCILLI and DOROTHY CAPPUCCILLI,

PETER L. CAPPUCCILLI and GRACE A. CAPPUCCILLI,

Petitioners-Appellants,

—*vs.*—

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

On Appeal from the United States Tax Court

APPELLANTS' REPLY BRIEF

VICTOR CHINI, ESQ.
Attorney for Petitioners-Appellants
Office and Post Office Address
811 State Tower Building
Syracuse, New York 13202

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TABLE OF CONTENTS

		Page
Point I.	Section 482 should not apply to purchase money mortgages in this case.	1
Point II.	Taxpayers did establish that unstated interest was included in the price at which CCP sold real estate to Stonehedge and Seneca.	1
Point III.	Section 482 should not apply to allocate income to CCP where the obligor's financial situation was such that interest could not have been paid.	3
Conclusion.		4

CITATIONS

Case:

Atchison, Topeka & Santa Fe Railway Co. v. Commissioner, 36 T.C. 584 (1961) 4

APPELLANTS' REPLY BRIEF

POINT I.

SECTION 482 SHOULD NOT APPLY TO PURCHASE MONEY MORTGAGES IN THIS CASE.

The Regulations under Section 482 do not provide for the allocation of interest income in situations involving the sale of capital assets. On page 10 of his Brief, the Commissioner argues that the exclusion of debts arising from the sale of capital assets would create a loop hole in the law. However, Section 483 provides for the inclusion of interest with respect to sales of capital assets on a time basis in which interest is not separately stated. Therefore, the loop hole which the Commissioner is concerned about simply does not exist.

On page 11 of his Brief, the Commissioner states that, "the record does not indicate that the land involved was set aside as investment property or otherwise segregated from ordinary stock in trade". Peter Cappuccilli testified that the subject property was purchased and held for investment and speculation and not for sale in the ordinary course of business (114(a), 118(a). Also the farms in question were not shown as inventory although some were owned at the end of 1961 (J. Ex. 10-J, 11-K).

POINT II.

TAXPAYERS ESTABLISHED THAT UNSTATED INTEREST WAS INCLUDED IN THE PRICE AT WHICH CCP SOLD REAL ESTATE TO STONEHEDGE AND SENECA.

In their Brief (pages 26-31), taxpayers argued that the sales of real estate made from CCP to Stonehedge and Seneca were made at a price which exceeded fair market value at that time and that this was attributable to an interest element. The Commissioner pointed out in his Brief on page 13, that Peter Cappuccilli subscribed, "under penalty of perjury, to declarations that there was no agreement providing for the payment of interest...." However, it was obvious that Mr. Cappuccilli signed the protest in haste because two of the three obligations involved interest bearing mortgages.

On page 13 of his Brief, the Commissioner raised the question that no explanation was given for the discrepancies in the interest range of 7-1/2% to 12%. However, as was stated in taxpayers' Brief, as long as interest of at least 5% was included, the requirements of Section 482 would have been satisfied. It should be noted that in his Brief, the Commissioner did not dispute the amount of the interest element included in the selling price; nor did he dispute the fair market value at the time of sale of the subject properties involved; nor did he dispute the fact that in all the sales of real estate involved, the fair market value at the time of sale exceeded the cost by a substantial amount; nor did the Commissioner attempt to explain what the difference between fair market value and the cost (of all the properties sold) was attributable to. The Commissioner's main argument in this regard is that the

Tax Court did not believe Mr. Cappuccilli's testimony that interest was intended to be included in the sales price.

By the passage of Section 483 Congress recognized that sales made on a time basis included an element of interest if interest was not separately stated in the agreement. Nowhere in his Brief did the Commissioner dispute or comment on the application of Section 483 to the sales of real estate by CCP to Stonehedge and Seneca.

POINT III.

SECTION 482 SHOULD NOT APPLY TO ALLOCATE INCOME TO CCP WHERE THE OBLIGOR'S FINANCIAL SITUATION WAS SUCH THAT INTEREST COULD NOT HAVE BEEN PAID.

On page 5 and 6 of his Brief, the Commissioner argues that Stonehedge, Seneca and Cappy's paid interest to other creditors but not to CCP. However, as was pointed out in taxpayers' Brief on page 38, CCP made advances to these companies in order to allow them to pay other creditors and to keep Stonehedge, Seneca and Cappy's in operation because they could not borrow from banks. (122(a), 123(a).

The Commissioner on pages 16 and 17 of his Brief, makes the point that a controlled taxpayer should be placed on a par with an uncontrolled taxpayer in its dealings with related parties. However, if as between non-related parties, interest would not have been taxable to the obligee because of the obligor's financial inability to pay interest, then this standard should also be applied to loans involving related parties.

Otherwise as was mentioned in taxpayers' Brief on page 42, a more burdensome rule of taxation would apply to related party loans. It should be noted that the Commissioner in his Brief did not dispute the fact that discrimination would result if an obligee were required to report interest income on a related party loan but not on non-related party loans, in situations where both obligors (related and non-related) were in such financial straits that they could not pay their interest obligations.

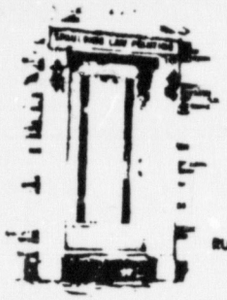
On page 14 of his Brief, the Commissioner cites Atchison, Topeka & Santa Fe Railway Co. v. Commissioner, 36, T.C. 584 (1961) for the proposition that this Court in Forman rejected the argument of insufficient funds relative to Section 482 interest allocations. However, that case is inapposite because Gulf, the subsidiary involved, had earnings in excess of current interest (page 595). Also it would appear that the other cases cited by this Court in Forman (page 1156) are not squarely in point on the proposition that the financial situation of the obligor has no bearing with respect to the allocation of interest in Section 482 cases.

CONCLUSION

The Tax Court decision should be reversed and judgment entered in favor of petitioners-appellants.

Respectfully submitted,

VICTOR CHINI
Attorney for Petitioners-
Appellants
811 State Tower Building
Syracuse, New York 13202



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Re: Paduano and Cappuccilli v. Commissioner of Internal Revenue
~~XXXXXX~~. Docket No. 75-4138

Dear Sir:

Enclosed please find copies of the above entitled for filing as follows:

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~~XX~~

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